

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER 98-0195
STATE GROSS RETAIL TAXES
For Years 1992, 1993, and 1994**

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ISSUES

I. Sales Tax Assessed on the Purchase of Safety Equipment: Sound Abatement and Dust Collection Systems.

Authority: IC 6-2.5-2-1; IC 6-2.5-5-1 to 38.2; IC 6-2.5-5-3(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(F).

Taxpayer protests the assessment of sales tax on the purchase of equipment, installed at taxpayer's steel production facility, purportedly for the purposes of preventing injuries to its employees and for compliance with relevant OSHA standards.

II. Sales Tax Assessed on the Purchase of In Process Material Handling Equipment for Transport of Work-In Process: Overhead Crane Rails and Crane Rail Clips.

Authority: 45 IAC 2.2-5-8(f)(3).

Taxpayer protests the assessment of sales tax on the purchase of materials and supplies used to construct material handling equipment used to transport work-in-progress.

III. Gross Retail and Use Tax on Materials Incorporated Into Realty: Direct Payment Permits Issued to Contractors.

Authority: IC 6-2.5-4-1(b); IC 6-2.5-4-1(c)(2); IC 6-2.5-4-9; IC 6-2.5-8-9; IC 6-2.5-8-9(a); 45 IAC 2.2-4-21(a); 45 IAC 2.2-4-22(e); 45 IAC 2.2-4-26(a); 45 IAC 2.2-4-26(b); 45 IAC 2.2-4-26(c); IAC 2.2-8-16(c);

Taxpayer protests the assessment of sales tax on materials incorporated into its real property, acquired through lump sum contracts for which taxpayer issued the contractor, purchasing those materials, a Direct Payment Permit.

IV. Sales Tax Assessed on the Purchase of Ore and Limestone Material Handling Equipment: Constituent Parts of Taxpayer's Ore Bridge; Clam Bucket, Hoists, Motors, Crane, and Vertical Trestles.

Authority: IC 6-2.5-5-3; IC 6-2.5-5-3(b); 45 IAC 2.2-5-8; 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(f)(1); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); Indiana Dept. of Revenue v. Kimball Int'l, 520 N.E.2d 454 (Ind. App. 1988).

Taxpayer protests the assessment of sales tax on the purchase of ore and limestone material handling equipment used at taxpayer's steel production facility.

Statement of Facts

Taxpayer is a steel producer operating steel plants throughout the world including a facility located in Indiana. Taxpayer's headquarters is located outside of Indiana.

DISCUSSION

I. Sales Tax Assessed on the Purchase of Safety Equipment: Sound Abatement and Dust Collections Systems.

Taxpayer protests the assessment of sales tax on the purchase of equipment, installed at taxpayer's steel production facility, purportedly for the purposes of preventing injuries to its employees and for compliance with OSHA standards.

Indiana imposes a gross retail (sales) tax on retail transactions in Indiana. IC 6-2.5-2-1. The legislature has provided a number of exemptions for the imposition of that tax. *See* IC 6-2.5-5-1 to 38.2. One of the exemptions provided is found under IC 6-2.5-5-3(b).

IC 6-2.5-5-3(b) exempts from sales tax liability those "[t]ransactions involving manufacturing machinery, tools, and equipment" and states that such transactions "are exempt from the state gross retail tax if the person acquiring that property acquires it for *direct use in the direct production*, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." (Emphasis added).

The Department has issued regulations interpreting the exemption provisions. In this case, the applicable regulation is found at 45 IAC 2.2-5-8(F). Under that regulation property, exempt under IC 6-2.5-5-3(b), has the requisite "direct use" and is consequently exempt under IC 6-2.5-5-3(b) if it has "an immediate effect on the article being produced" and is an "essential and integral part of an integrated process which produces tangible personal property." 45 IAC 2.2-5-8(c). Specifically, under 45 IAC 2.2-5-8(F), "[s]afety clothing or equipment which is required to allow a worker to participate in the

production process without injury” comes within the definition of equipment which is part of the taxpayer’s integrated production process and is, therefore, exempt.

Taxpayer argues that its “Ladle Active Dust Collection System” and “Temper and Tandem Mill Enclosures” fall within the exemption provided under 45 IAC 2.2-5-8(F).

Taxpayer asserts that its installation of “Temper and Tandem Mill Enclosures” was required to reduce noise to acceptable levels. Prior to taxpayer’s decision to install this equipment, taxpayer conducted noise exposure monitoring to determine the level of noise its individual workers were exposed. The monitoring, conducted in April of 1993, determined that taxpayer’s individual workers were routinely exposed to noise levels of between 93 to 99 decibels measured on an “A” weighted scale. Taxpayer Departmental Correspondence, Sept. 15, 1993, Table I, p. 3. Monitoring of different locations within the affected area indicated sound levels of between 86 to 105 decibels. *Id.* at Table II, p. 4. At those levels, OSHA standards, 29 C.F.R. 1910.95, require that workers so affected be enrolled in a hearing conservation program and wear hearing protection. *Id.* at p. 1. Those regulations further “call[] for the implementation of engineering controls in order to

Id. The noise exposure monitoring led to taxpayer’s decision to install sound enclosures at its Flat Rolled Finishing Temper Mill in order to moderate the level of noise produced and to protect the workers involved. Capital Project Request, July 15, 1993. The “Temper and Tandem Mill Enclosures” used to moderate noise levels are located within taxpayer’s production process. The temper mill operates after the steel annealing process and immediately prior to the steel galvanizing process.

Taxpayer’s “Ladle Active Dust Collection System” is designed to capture the dust emitted at each additive transfer location. Taxpayer conducted air monitoring and sampling to determine the level of dust to which its workers were exposed at its ladle additive system. The results indicated the following: (1) samples collected exceeded the limit for total particulate, (2) samples collected exceeded the limit for airborne metal contaminants, (3) samples collected exceeded the limit for airborne manganese contaminants. Taxpayer Corporation Request for Approval, Oct. 12, 1990, p. 2. In order to achieve compliance with OSHA standard, 29 C.F.R. 1910.1000, bringing worker exposure with the Permissible Exposure Limits, taxpayer elected to install a dust collection system at the four transfer points of its ladle additive system. *Id.* This dust collection system operates within taxpayer’s continuous production process because is located midway between the initial steps producing raw iron and the final steps processing finished steel. The system is located adjacent to the basic oxygen furnace and operates to remove and collect dust from the area where alloy materials are batched, weighed, and ultimately discharged into the steel produced in the basic oxygen furnace.

Taxpayer’s purchase of sound abatement and dust collection equipment falls within the requirements of IC 6-2.5-5-3(b) and 45 IAC 2.2-5-8(F). Taxpayer’s Temper and Tandem Mill Enclosures and Ladle Active Dust Collection System are “equipment which is required to allow a worker to participate in the production process without injury.” 45 IAC 2.2-5-8(F).

FINDING

Taxpayer's protest is sustained.

DISCUSSION

II. Sales Tax Assessed on the Purchase of In Process Material Handling Equipment: Overhead Crane Rails and Crane Rail Clips.

Taxpayer protests the assessment of sales tax on the purchase of equipment and supplies used to construct material handling equipment. Specifically, the equipment and supplies in question, crane rails and rail clips, are part of a tracked, overhead gantry-like device. The device is used to transport ladle buckets, containing molten steel, from taxpayer's basic oxygen furnace to the continuous caster where steel slabs are produced.

45 IAC 2.2-5-8(f)(3) provides that "[t]ransportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to [sales] tax if the transportation is within the production process."

The molten steel fits the description of "work-in-process or semi-finished materials." The molten steel results from taxpayer's blast furnace acting upon raw materials to produce molten iron. The molten iron is transported to the basic oxygen furnace which then acts upon the molten iron to produce steel. It is at this point that the equipment at issue is used to transport the molten steel to the continuous caster. The continuous caster then acts upon the molten steel to produce slab steel.

Because this equipment is used to transport work-in-progress within taxpayer's continuous steel production process, the equipment is not subject to sales tax.

FINDING

Taxpayer's protest is sustained.

DISCUSSION

III. Gross Retail and Use Tax on Materials Incorporated Into Realty: Direct Payment Permit Issued to Contractors.

Taxpayer protests the assessment of sales tax on materials incorporated into its real property.

During the period of time covered by the audit report, taxpayer issued purchase orders for lump sum improvements to taxpayer's realty which stated that its tax status was that of a

taxpayer holding a Direct Pay Permit. In some cases, taxpayer wrote on the purchase order:

Contractor is responsible to pay any state sales or use taxes on items consumed by the contractor and any building materials incorporated into real property or improvements to land. Certain structures may not be considered real property and the sales tax exemption should be requested from Taxpayer.

Additionally, during taxpayer's pre-bid meetings with contractors, held to review and clarify contract terms and conditions, taxpayer purportedly emphasized the contractors' ultimate responsibility for state taxes. The contracts between taxpayer and its contractors typically contained a provision instructing the contractor to include all Indiana sales and use taxes in the lump sum contract price. That provision stated that taxpayer was "exempt from tax" because tax was included in the contract price.

Accordingly, taxpayer maintains that it is not now responsible for gross retail or use tax on materials incorporated into its real property and that there is no law, rule, or case law passing that tax liability onto the taxpayer if the contractor does not recognize his legal sales or use tax liability.

Taxpayer's use of its Direct Payment Permit, issuance of lump sum contracts, and practice of representing to its contractors that it is "tax free" have intertwined a number of issues each of which will be addressed separately.

Taxpayer is not subject to use tax liability for those transactions for which taxpayer either issued a purchase order or contracted for an improvement to taxpayer's realty on the basis of lump sum contracts. Under 45 IAC 2.2-4-22(e), "With respect to construction material a contractor acquired-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner: (1) He converts material into realty on land he owns and then sells the improved real estate; (2) He utilizes the construction material for his own benefit; or (3) Lump sum contract. *He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.*" (Emphasis added). In the lump sum contracts between taxpayer and its contractors, it is the contractor who is ultimately responsible for paying the tax to its own supplier. 45 IAC 2.2-4-26(a) provides that "[a] person (the contractor) making a contract for the improvement to real estate whereby the material becoming a part of the improvement and the labor are quoted as one price is liable for the payment of sales tax on the purchase price of all material so used."

Therefore, for those lump sum contracts, involving improvement to its realty, in which the cost of material and the labor were stated as one price, it is the contractor and not taxpayer who retains responsibility for the payment of sales tax. Further, under 45 IAC 2.2-4-26(b), "the fact that seller (contractor) subsequently furnished information regarding the charges for labor and material used under a flat bid quotation shall not be considered to constitute separate transactions for labor and material."

Conversely, for those transactions in which taxpayer contracted for or received a statement in which the cost of materials and labor was stated separately, taxpayer retains responsibility for sales tax liability on the cost of the materials transferred. Taxpayer has, in effect, engaged in a retail transaction with its contractor. IC 6-2.5-4-1(b). The fact that the material was “transferred alone in or in conjunction with other property or services,” IC 6-2.5-4-1(c)(2), is irrelevant. Under 45 IAC 2.2-4-21(a), “[t]he conversion of tangible personal property into realty does not relieve a liability for any owing and unpaid state gross retail tax or use tax with respect to such tangible personal property.” An exception is provided under 45 IAC 2.2-4-26(c) for tangible personal property, purchased to become part of an improvement to real estate, when the organization is entitled to an exemption. However, taxpayer’s bare assertion that it is “tax free” does not constitute such an exemption. Neither does taxpayer’s holding of a Direct Payment Permit constitute an exemption. 45 IAC 2.2-8-16(c) clearly states that “[a] direct payment permit is not a declaration that the issuer is entitled to [an] exemption, but rather is a declaration that the issuer will remit use tax on any purchase on which sales tax is due.”

Therefore, under the conditions whereby taxpayer originally obtained its Direct Pay Permit, taxpayer is responsible to the Department for use tax on the material portion of contracts for improvements to its realty, in which the cost of labor and material were separately stated. That responsibility is not alleviated by any agreements or understandings between taxpayer and its contractors regarding the allocation of tax liabilities. Although those agreements and understandings are of some interest to the parties involved, they are not dispositive of the sales and use tax liability taxpayer acquired under IC 6-2.5-4-9.

Taxpayer is reminded of the conditions under which it has been issued the Direct Payment Permit and the purpose for which that permit is intended. The Direct Payment Permit is not a declaration that a taxpayer is entitled to a tax exemption. Instead, it is an agreement between the taxpayer and the Department that the taxpayer will “pay the tax . . . directly to the department.” IC 6-2.5-8-9. The Direct Payment Permit merely allows the taxpayer the option of determining the taxability of the purchased items at a later time. If those items are then determined to be taxable, the taxpayer must remit the use tax. Taxpayer’s Direct Pay Permit was issued and remains subject to those conditions the Department deems reasonable. IC 6-2.5-8-9(a). Among those conditions include the stipulation that “[d]irect payment permits do not certify that the issuer is entitled to an exemption and *may not be issued to flat bid (lump sum) contractors.*” Ind. Dept. of Revenue Application for Direct Pay Authorization (Emphasis added). If the contractor with whom taxpayer is dealing does not provide a separate breakdown of the costs of materials, “the Direct Payment Permit cannot be used for the lump sum contract.” Sales Tax Division Information Bulletin #38.

FINDING

Taxpayer’s protest is denied in part and sustained in part.

DISCUSSION

IV. Sales Tax Assessed on the Purchase of Ore and Limestone Material Handling

Equipment: Constituent Parts of Taxpayer's Ore Bridge; Clam Bucket, Hoists, Motors, Crane, and Vertical Trestles.

Taxpayer protests the assessment of sales tax on its purchase of equipment and supplies incorporated into taxpayer's ore bridge. The ore bridge, an overhead trestle construction upon which a movable clam bucket operates, is located at taxpayer's steel plant and is used to transport iron ore pellets and limestone. These iron ore pellets and limestone are purchased from third-party suppliers and delivered to taxpayer's steel production facility by boat. Upon delivery, these raw materials are off-loaded and then transferred by the ore bridge clam bucket to and temporarily stored in a marshalling yard. As needed, the iron ore pellets and limestone are brought to the blast furnace. A clam bucket (referred to as "grab bucket" in the audit report), motors, hoists, vertical trestles, and ore bridge crane move the ore pellets and limestone from the ore yard to a transfer car for melting in the blast furnace. Taxpayer asserts that it is at this point that the raw materials are "committed to the iron making process and not returned."

Taxpayer bases its protest on IC 6-2.5-5-3. IC 6-2.5-5-3(b) provides an exemption from sales tax for "manufacturing machinery, tools and equipment . . . if the person acquiring that property acquires it for his direct use in the direct production (or) manufacture . . . of other tangible personal property." To qualify for exemption from sales and use tax, machinery and equipment must be directly used in the production process. Further, the equipment must have an immediate effect on the article being produced. "Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property." 45 IAC 2.2-5-8(c).

Taxpayer asserts that the clam bucket, hoists, motors, vertical trestle, and ore bridge crane are directly used in and are an integral part of the production of steel. In support of that argument taxpayer compares its own material handling equipment to the stone quarry transportation equipment at issue in Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983). In that case, the court held that transportation equipment used in taxpayer's aggregate stone production process was exempt from sales tax because the equipment was essential to achieving the transformation of crude stone into aggregate stone. The court held that the equipment played an integral part in the ongoing process of transformation of the final product. In arriving at that decision, the Cave Stone court held that the focus of analysis should be whether the equipment was an integral part of manufacturing and operated directly on the product during production. *Id.* at 525.

In applying any tax exemption, including the exemption found within 45 IAC 2.2-5-8(c), the general rule is that "tax exemptions are strictly construed in favor of taxation and Indiana Department of Revenue v. Kimball Int'l, 520 N.E.2d 454, 456 (Ind. App. 1988).

In addressing the issue raised by taxpayer, example 10, found at 45 IAC 2.2-5-8 is instructive because the situation described is closely analogous to taxpayer's. "A crane is used to unload a barge delivering raw materials to a steel plant where the raw materials are stockpiled in a storage yard adjacent to the plant. The crane is taxable."

The question of the taxability of taxpayer's ore bridge equipment is also directly addressed in 45 IAC 2.2-5-8(f)(1) which states that transportation equipment "used for moving raw materials to the plant prior to their entrance into the production process is taxable."

Taxpayer is correct in citing Cave Stone for the proposition that the "double direct" standard is met when the item used or consumed is an essential and integral part of an integrated production process. Cave Stone, 457 N.E.2d at 524. However, taxpayer's ore bridge equipment is not part of the integrated process producing steel at taxpayer's mill. At taxpayer's steel mill, the ore bridge equipment is used to transport off-loaded raw materials to the marshalling yard and then from the marshalling yard to the blast furnace. The ore bridge equipment is not equipment which has an immediate effect on the steel being produced. It is, instead, a separate unit of machinery both distinct and removed from the actual production of steel. The ore bridge equipment simply functions to transport raw material from one place to another at a point outside the actual steel production process. The limestone and ore pellets are not changed during the time they are being transported by the ore bridge equipment. During the time the ore bridge equipment is acting upon them, the materials are not mixed, altered, combined, or changed in form. As such, the equipment is not integral to the production of steel.

Taxpayer's reference to Cave Stone is inapposite. In that case, the court held that the transportation equipment at issue played an integral part in the production of aggregate stone because the production of taxpayer's product began at the time of "initial stripping, drilling, and blasting at the quarry and end[ed] at the time the stone [was] stockpiled." Cave Stone, 457 N.E.2d at 524. The court found that the transportation equipment moved the unfinished stone in a continuous flow *from one production step to another* with the equipment playing an integral part in the *ongoing process of transformation*. *Id.* at 524-25 (Emphasis added).

FINDING

Taxpayer's protest is respectfully denied.